

## EDITORIAL

### Recent trends and events

The Hong Kong economy continued on its path of sustained recovery during the first and second quarters of 2005. Real Gross Domestic Product grew by 6.0% year on year during the first quarter of 2005, helped by strong exports and healthy domestic demand. The pace of expansion in employment has increased in recent months, leading to a faster decline in the unemployment rate, to 5.9% in the three months to April, the lowest level in 41 months. The annual rate of consumer price inflation stabilised at 0.5% in April, compared with 0.8% in the previous two months. The number of residential mortgage loans in negative equity continued to decline, to 14,000 cases at the end of March, compared with the peak of 106,000 cases in June 2003. The Hang Seng Index moved between 13,400 and 14,000, closing at 13,867 on 31 May.

On 18 May the HKMA made refinements to the Linked Exchange Rate system by introducing a strong-side Convertibility Undertaking at 7.75 Hong Kong dollars to the US dollar, and announcing the shifting of the existing weak-side Convertibility Undertaking from 7.80 to 7.85. These refinements were aimed at removing uncertainty about the extent to which the exchange rate may strengthen under the Linked Exchange Rate system and promoting the smooth functioning of the money and foreign exchange markets in accordance with Currency Board arrangements. Immediately following the announcement, the Aggregate Balance shrank from HK\$3.8 billion to less than HK\$1 billion, before returning to HK\$1.2 billion at the end of May. The US FOMC raised the federal funds target rate by a cumulative 50 basis points in its March and May meetings. As a result, and on the back of tighter liquidity in the domestic interbank market, banks in Hong Kong raised their best lending rates by about one percentage point in the past three months.

Helped by increased tax revenue and better-than-expected cost-cutting efforts, the Government recorded a slight provisional deficit of HK\$4.6 billion (after excluding the HK\$26 billion one-off revenues raised by issuing bonds) in the fiscal year 2004/05. The HKMA launched a new Retail Exchange Fund Notes programme in May, offering up to HK\$300 million of the two-year issue for non-competitive tender. On 30 May the HKMA, the Hong Kong Association of Banks and the Hong Kong Police Force jointly announced the launch of two-factor authentication for Internet banking by the banking industry.

## In this issue

This issue of the *Quarterly Bulletin* contains the regular Half-Yearly Monetary and Financial Stability Report, which, among other things, examines the impact of the refinements to the Linked Exchange Rate system introduced on 18 May. A feature article presents a monetary conditions index for Mainland China, and suggests that there was a distinct easing of monetary conditions in 2002-2003 before a partial reversal in 2004, which contributed to the strong economic growth in recent years. Another article, on the relationship between commodity and consumer prices in Mainland China and Hong Kong, explores how changes in non-fuel commodity prices help to predict headline CPI inflation on the Mainland and in Hong Kong. The third feature article reports on the results of the 2004 survey on credit derivatives and asset securitisation activity.